(ii) The recomputed qualified investment with respect to such property (determined under the principles of paragraph (a) of § 1.47–1).

(3) This paragraph may be illustrated by the following examples:

Example 1. (i) A acquired and placed in service on January 1, 1962, machine No. 1, which qualified as section 38 property, with a basis of $30,000 and an estimated useful life of 6 years. The amount of qualified investment with respect to such machine was $20,000. On January 2, 1963, machine No. 1 is completely destroyed by fire. On January 1, 1963, the adjusted basis of such machine in A's hands is $24,500. On November 1, 1963, A receives $23,000 in insurance proceeds as compensation for the destroyed machine, and on December 15, 1963, A acquires and places in service machine No. 2, which qualifies as section 38 property, with a basis of $41,000 and an estimated useful life of 6 years to replace machine No. 1.

(ii) Under subparagraph (1) of this paragraph, the $41,000 basis of machine No. 2 is reduced, for purposes of paragraph (a) of this section, by $23,000 (that is, the $23,000 insurance proceeds since such amount is less than the $24,500 adjusted basis of machine No. 1 immediately before it was destroyed) to $18,000 since such reduction (that is, $23,000) is greater than the $20,000 reduction in qualified investment which would be made if paragraph (a) of § 1.47–1 were to apply to machine No. 1 ($20,000 qualified investment less zero recomputed qualified investment).

Example 2. (i) The facts are the same as in *Example 1* except that on November 1, 1963, A receives only $19,000 in insurance proceeds as compensation for the destroyed machine.

(ii) The $41,000 basis of machine No. 2 is not reduced, for purposes of paragraph (a) of this section, under this paragraph since the $19,000 reduction which would have been made under this paragraph had it applied (that is, the $19,000 insurance proceeds since such amount is less than the $24,500 adjusted basis of machine No. 1 immediately before it was destroyed) is less than the $20,000 reduction in qualified investment which is made since paragraph (a) of § 1.47–1 applies to machine No. 1 ($20,000 qualified investment less zero recomputed qualified investment).

(Secs. 194 (94 Stat. 1989; 26 U.S.C. 194) and 7805 (68A Stat. 917, 26 U.S.C. 7805) of the Internal Revenue Code of 1954; secs. 38(b) (76 Stat. 963, 26 U.S.C. 38(b)), 48(l)(16) (94 Stat. 264, 26 U.S.C. 48(l)(16)), and 7805 (68A Stat. 917, 26 U.S.C. 7805)

[T.D. 6731, 29 FR 6068, May 8, 1964, as amended by T.D. 6931, 32 FR 14026, Oct. 10, 1967; T.D. 7203, 37 FR 17125, Aug. 25, 1972; T.D. 7602, 44 FR 17667, Mar. 23, 1979; T.D. 7927, 48 FR 55849, Dec. 16, 1983; T.D. 7982, 49 FR 39541, Oct. 9, 1984; T.D. 8183, 53 FR 6618, Mar. 2, 1988; T.D. 8474, 58 FR 25557, Apr. 27, 1993]

§ 1.46–4 Limitations with respect to certain persons.

(a) *Mutual savings institutions.* In the case of an organization to which section 593 applies (that is, a mutual savings bank, a cooperative bank, or a domestic building and loan association)—

(1) The qualified investment with respect to each section 38 property shall be 50 percent of the amount otherwise determined under § 1.46–3, and

(2) The $25,000 amount specified in section 46(a)(2), relating to limitation based on amount of tax, shall be reduced by 50 percent of such amount.

For example, if a domestic building and loan association places in service on January 1, 1963, new section 38 property with a basis of $30,000 and an estimated useful life of 6 years, its qualified investment for 1963 with respect to such property computed under § 1.46–3 is $20,000 (66⅔ percent of $30,000). However, under this paragraph such amount is reduced to $10,000 (50 percent of $20,000). If an organization to which section 593 applies is a member of an affiliated group (as defined in section 46(a)(5)), the $25,000 amount specified in section 46(a)(2) shall be reduced in accordance with the provisions of paragraph (f) of § 1.46–1 before such amount is further reduced under this paragraph.

(b) *Regulated investment companies and real estate investment trusts.* (1) In the case of a regulated investment company or a real estate investment trust subject to taxation under subchapter M, chapter 1 of the Code—

(i) The qualified investment with respect to each section 38 property otherwise determined under § 1.46–3, and

(ii) The $25,000 amount specified in section 46(a)(2), relating to limitation based on amount of tax,

shall be reduced to such person's ratable share of each such amount. If a regulated investment company or a real estate investment trust is a member of an affiliated group (as defined in section 46(a)(5)), the $25,000 amount specified in section 46(a)(2) shall be reduced in accordance with the provisions of paragraph (f) of §1.46–1 before such amount is further reduced under this paragraph.

(2) A person's ratable share of the amount described in subparagraph (1)(i) and the amount described in subparagraph (1)(ii) of this paragraph shall be the ratio which—

(i) Taxable income for the taxable year, bears to

(ii) Taxable income for the taxable year plus the amount of the deduction for dividends paid taken into account under section 852(b)(2)(D) in computing investment company taxable income, or under section 857(b)(2)(B) (section 857(b)(2)(C), as then in effect, for taxable years ending before October 5, 1976) in computing real estate investment trust taxable income, as the case may be.

For purposes of the preceding sentence, taxable income means, in the case of a regulated investment company its investment company taxable income (within the meaning of section 852(b)(2)), and in the case of a real estate investment trust its real estate investment trust taxable income (within the meaning of section 857(b)(2)). In the case of a taxable year ending after October 4, 1976, real estate investment trust taxable income, for purposes of section 46(e) and this paragraph, is determined by excluding any net capital gain, and by computing the deduction for dividends paid without regard to capital gains dividends (as defined in section 857(b)(3)(C)). The amount of the deduction for dividends paid includes the amount of deficiency dividends (other than capital gains deficiency dividends) taken into account in computing investment company taxable income or real estate investment trust taxable income for the taxable year. See section 860(f) for the definition of deficiency dividends. For purposes of this paragraph only, in computing taxable income for a taxable year beginning before January 1, 1964, a regulated investment company or a real estate investment trust may compute depreciation deductions with respect to section 38 property placed in service before January 1, 1964, without regard to the reduction in basis of such property required under §1.48–7.

(3) This paragraph may be illustrated by the following example:

Example. (i) Corporation X, a regulated investment company subject to taxation under section 852 of the Code which makes its return on the basis of the calendar year, places in service on January 1, 1964, section 38 property with a basis of $30,000 and an estimated useful life of 6 years. Corporation X's investment company taxable income under section 852(b)(2) is $10,000 after taking into account a deduction for dividends paid of $90,000.

(ii) Under this paragraph, corporation X's qualified investment for the taxable year 1964 with respect to such property is $2,000, computed as follows: *(a)* $20,000 (qualified investment under §1.46–3), multiplied by *(b)* $10,000 (taxable income), divided by *(c)* $100,000 (taxable income plus the deduction for dividends paid). For 1964, the $25,000 amount specified in section 46(a)(2) is reduced to $2,500.

(c) *Cooperatives.* (1) In the case of a cooperative organization described in section 1381(a)—

(i) The qualified investment with respect to each section 38 property otherwise determined under §1.46–3, and

(ii) The $25,000 amount specified in section 46(a)(2), relating to limitation based on amount of tax,

shall be reduced to such cooperative's ratable share of each such amount. If a cooperative organization described in section 1381(a) is a member of an affiliated group (as defined in section 46(a)(5)), the $25,000 amount specified in section 46(a)(2) shall be reduced in accordance with the provisions of paragraph (f) of §1.46–1 before such amount is further reduced under this paragraph.

(2) A cooperative's ratable share of the amount described in subparagraph (1)(i) and the amount described in subparagraph (1)(ii) of this paragraph shall be the ratio which—

(i) Taxable income for the taxable year, bears to

(ii) Taxable income for the taxable year plus the sum of *(a)* the amount of the deductions allowed under section

1382(b), *(b)* the amount of the deductions allowed under section 1382(c), and *(c)* amounts similar to the amounts described in *(a)* and *(b)* of this subdivision the tax treatment of which is determined without regard to subchapter T, chapter 1 of the Code and the regulations thereunder.

Amounts similar to deductions allowed under section 1382 (b) or (c) are, for example, in the case of a taxable year of a cooperative organization beginning before January 1, 1963, the amount of patronage dividends which are excluded or deducted and any nonpatronage distributions which are deducted under section 522(b)(1). In the case of a taxable year of a cooperative organization beginning after December 31, 1962, such amounts are the amount of patronage dividends and nonpatronage distributions which are excluded or deducted without regard to section 1382 (b) or (c) because they are paid with respect to patronage occurring before 1963. For purposes of this paragraph only, in computing taxable income for a taxable year beginning before January 1, 1964, a cooperative may compute depreciation deductions with respect to section 38 property placed in service before January 1, 1964, without regard to the reduction in basis of such property required under §1.48–7.

(3) This paragraph may be illustrated by the following example:

Example. (i) Cooperative X, an organization described in section 1381(a) which makes its return on the basis of the calendar year, places in service on January 1, 1964, section 38 property with a basis of $30,000 and an estimated useful life of 6 years. Cooperative X's taxable income is $10,000 after taking into account deductions of $20,000 allowed under section 1382(b), deductions of $60,000 allowed under section 1382(c), and deductions of $10,000 allowed under section 522(b)(1)(B).

(ii) Under this paragraph, cooperative X's qualified investment for the taxable year 1964 with respect to such property is $2,000, computed as follows: *(a)* $20,000 (qualified investment under §1.46–3), multiplied by *(b)* $10,000 (taxable income), divided by *(c)* $100,000 (taxable income plus the sum of the deductions allowed under sections 1382(b), 1382(c), and 522(b)(1)(B)). For 1964, the $25,000 amount specified in section 46(a)(2) is reduced to $2,500.

(d) *Noncorporate lessors.* (1) In the case of a lease entered into after September 22, 1971, a credit is allowed under section 38 to a noncorporate lessor of property with respect to the leased property only if—

(i) Such property has been manufactured or produced by the lessor in the ordinary course of his business, or

(ii) The term of the lease (taking into account any options to renew) is less than 50 percent of the estimated useful life of the property (determined under §1.46–3(e)), and for the period consisting of the first 12 months after the date on which the property is transferred to the lessee the sum of the deductions with respect to such property which are allowable to the lessor solely by reason of section 162 (other than rents and reimbursed amounts with respect to such property) exceeds 15 percent of the rental income produced by such property.

In the case of property of which a partnership is the lessor, the credit otherwise allowable under section 38 with respect to such property to any partner which is a corporation shall be allowed notwithstanding the first sentence of this subparagraph. For purposes of this subparagraph, an electing small business corporation (as defined in section 1371) shall be treated as a person which is not a corporation. This paragraph shall not apply to property used by the taxpayer in his trade or business (other than the leasing of property) for a period of at least 24 months preceding the day on which any lease of such property is entered into.

(2) For purposes of subparagraph (1)(ii) of this paragraph, if at the time the lessor files his income tax return for the taxable year in which the property is placed in service, the lessor is unable to show that the more-than-15-percent test has been satisfied, then no credit may be claimed by the lessor on such return with respect to such property unless (i) taking into account the lessor's obligations under the lease it is reasonable to believe that the more-than-15-percent test will be satisfied, and (ii) the lessor files a statement with his return from which it may be determined that he expects to satisfy the more-than-15-percent test. If the more-than-15-percent test is not satisfied with respect to the property, the taxpayer must file an amended return

for the year in which the property is placed in service.

(3)(i) The more-than-15-percent test described in subparagraph (1)(ii) of this paragraph is based on the relationship of the expenses of the lessor relating to or attributable to the property to the gross income from rents of the taxpayer produced by the property. The test is applied with respect to such expenses and gross income as are properly attributable to the period consisting of the first 12 months after the date on which the property is transferred to the lessee. When more than one property is subject to a single lease and, pursuant to subparagraph (4) of this paragraph, the arrangement is considered to be a separate lease of each property, the test is applied separately to each such lease by making an apportionment of the payments received and expenses incurred with respect to each such property, considering all relevant factors. Such apportionment is made in accordance with any reasonable method selected and consistently applied by the taxpayer. For example, under subparagraph (4) of this paragraph, where a taxpayer leases an airplane which he owns to an airline along with a baggage truck, he is treated as having made two separate leases, one covering the airplane and one covering the baggage truck. Thus, the test will be applied by apportioning the related income and expenses between the two leases. Similarly, where a taxpayer leases a factory building erected by him containing section 38 property (machinery and equipment), the test will be applied to the taxpayer as though he had leased (to the lessee) the building and the section 38 property separately. Thus, the rental income and expenses are apportioned between the building and the section 38 property.

(ii) Only those deductions allowable solely by reason of section 162 are taken into account in applying the more-than-15-percent test. Hence, depreciation allowable by reason of section 167 (including amortization allowable in lieu of depreciation); interest allowable by reason of section 163; taxes allowable by reason of section 164; and depletion allowable by reason of section 611 are examples of deductions which are not taken into account in applying the test. Moreover, rents and reimbursed amounts paid or payable by the lessor are not taken into account notwithstanding that a deduction in respect of such rents or reimbursed amounts is allowable solely by reason of section 162. For purposes of this paragraph, a reimbursed amount is any expense for which the lessee or some other party is obligated to reimburse the lessor. Section 162 expenses paid or payable by any person other than the lessor are not taken into account unless the lessor is obligated to reimburse the person paying the expense. Further, if the lessee is obligated to pay to the lessor a charge for services which is separately stated or determinable, the expenses incurred by the lessor with respect to those services are not taken into account.

(iii) For purposes of the more-than-15-percent test, the gross income from rents of the lessor produced by the property is the total amount which is payable to the lessor by reason of the lease agreement other than reimbursements of section 162 expenses and charges for services which are separately stated or determinable. The fact that such amount depends, in whole or in part, on the sales or profits of the lessee or the performance of significant services by the lessor shall not affect the characterization of such amounts as gross income from rents for purposes of this paragraph. Gross income from rents also includes any taxes imposed on the lessor by local law but which are paid directly by the lessee on behalf of the lessor.

(4) For purposes of determining under this paragraph whether property is subject to a lease, the provisions of §1.57–3(d)(1) (relating to definition of a lease) shall apply. If a noncorporate lessor enters into two or more successive leases with respect to the same or substantially similar items of section 38 property, the terms of such leases shall be aggregated and such leases shall be considered one lease for the purpose of determining whether the term of such leases is less than 50 percent of the estimated useful life of the property subject to such leases. Thus, for example, if an individual owns an airplane with an estimated useful life

of 7 years and enters into three successive 3-year leases of such airplane, such leases will be considered to be one lease for a term of nine years for the purpose of determining whether the term of the lease is less than 3½ years (50 percent of the 7-year estimated useful life).

(5) The requirements of this paragraph shall not apply with respect to any property which is treated as section 38 property by reason of section 48(a)(1)(E).

(Sec. 860(e) (92 Stat. 2849, 26 U.S.C. 860(e)); sec. 860(g) (92 Stat. 2850, 26 U.S.C. 860(g)); and sec. 7805 (68A Stat. 917, 26 U.S.C. 7805))

[T.D. 6731, 29 FR 6071, May 8, 1964, as amended by T.D. 6958, 33 FR 9170, June 21, 1968; T.D. 7203, 37 FR 17126, Aug. 25, 1972; T.D. 7767, 46 FR 11262, Feb. 6, 1981; T.D. 7936, 49 FR 2105, Jan. 18, 1984; T.D. 8031, 50 FR 26697, June 28, 1985]

§ 1.46–5 Qualified progress expenditures.

(a) *Effective date.* This section applies to taxable years ending after December 31, 1974. This section reflects amendments to the Internal Revenue Code made only by the Tax Reduction Act of 1975, the Tax Reform Act of 1976, and the Revenue Act of 1978.

(b) *General rule.* Under section 46(d), a taxpayer may elect to take the investment credit for qualified progress expenditures (as defined in paragraph (g) of this section). In general, qualified progress expenditures are amounts paid (paid or incurred in the case of self-constructed property) for construction of progress expenditure property. The taxpayer must reasonably estimate that the property will take at least 2 years to construct and that the useful life of the property will be 7 years or more. Qualified progress expenditures may not be taken into account if made before the later of January 22, 1975, or the first taxable year to which an election under section 46(d) applies. In general, qualified progress expenditures are not allowed for the year property is placed in service, nor for the first year or any subsequent year recapture is required under section 47(a)(3). There is a percentage limitation on qualified progress expenditures for taxable years beginning before January 1, 1980. For a special rule relating to transfers of progress expenditure property, see paragraph (r) of this section.

(c) *Reduction of qualified investment.* Under section 46(c)(4), a taxpayer must reduce qualified investment for the year property is placed in service by qualified progress expenditures taken into account by that person or a predecessor. A ''predecessor'' of a taxpayer is a person whose election under section 46(d) carries over to the taxpayer under paragraph (o)(3) of this section.

(d) *Progress expenditure property.* Progress expenditure property is property constructed by or for the taxpayer, with a normal construction period of 2 years or more. The taxpayer must reasonably believe that the property will be new section 38 property with a useful life of 7 years or more when placed in service. Whether property is progress expenditure property is determined on the basis of facts know at the close of the taxable year of the taxpayer in which construction begins (or, if later, at the close of the first taxable year to which an election under section 46(d) applies). For purposes of this paragraph (d), property is constructed by or for the taxpayer only if it is built or manufactured from materials and component parts. Accordingly, progress expenditure property does not include property such as orchards, vineyards, livestock, or motion picture films or videotapes.

(e) *Normal construction period*—(1) *In general.* (i) The normal construction period is the period the taxpayer reasonably expects will be required to construct the property. The period begins on the date physical work on construction of the property commences and ends on the date the property is available to be placed in service. The normal construction period does not include, however, construction before January 22, 1975, nor construction before the first day of the first taxable year for which an election under section 46(d) is in effect. Physical work on construction of property does not include preliminary activities such as planning, designing, preparing blueprints, exploring, or securing financing.

(ii) The determination of the time when physical work on construction commences is based on the facts and